March 25, 2003

BY FACSIMILE AND FEDERAL EXPRESS

Ms. Kristi Izzo, Secretary
New Jersey Board of Public Utilities
Two Gateway Center
Newark, N.J. 07102

Re: Comments On and Clarifications
To the Final Audit Report on the Competitive
Service Offerings of New Jersey Natural Gas Company
BPU Docket No. GA02020100

Dear Secretary Izzo:

New Jersey Natural Gas Company ("NJNG" or the "Company") hereby submits an original and ten (10) copies of its comments on and clarifications, the Final Report (Redacted Version) submitted by Overland Consulting ("Overland") in the referenced docket on March 18, 2003 ("Final Report").

I. BACKGROUND

Ever since the Board adopted its Interim Affiliate Relations, Fair Competition and Accounting Standards and Related Reporting Requirements ("Affiliate Rules"), NJNG has been committed to consistently and proactively develop internal rules and compliance procedures that can serve as a model for the industry and set the highest possible standard for integrity and effectiveness. Indeed, following the adoption of the Affiliate Rules, and consistent with the recommendations made in the prior audit of NJNG's competitive services, NJNG formed a Service Corporation, received BPU approval to spin-out its appliance services business to Home Services, and developed and instituted several improvements to its management, accounting, and internal training programs to ensure that its efforts to comply with both the letter and spirit of the Affiliate Rules are truly second to none.

The audit conducted in this proceeding is the first opportunity the Company and the BPU have had to examine the degree to which the Company's compliance efforts have been effective and to identify areas in which still further improvements can be made. The Company is thus gratified to note (as discussed further below) that the Company's diligence to date in implementing changes to its business practices, accounting procedures and management structure have been recognized and found to be effective. The Final Report also provides an opportunity for the Company to consider and implement some additional recommendations that may serve to fine-tune several of the Company's internal processes and procedures.

II. GENERAL COMMENTS

The scope and purpose of Overland's audit engagement in this proceeding was defined in the Request for Proposal ("RFP") the Board issued in this proceeding on March 20, 2002. As the Board explained therein, the central purpose of the audit is to ensure that NJNG and its affiliates offering competitive retail services do not enjoy any unfair competitive advantage over other non-affiliated purveyors of competitive retail services. As to that paramount consideration, it is fair to conclude that the Final Report's ultimate findings, conclusions and recommendations confirm that NJNG and its affiliates offering competitive retail services do not enjoy any unfair competitive advantage over other competitive service providers.

The Final Report also confirms that NJNG has (a) adhered to and otherwise materially complied with the Affiliate Standards and related recommendations that have been adopted by the Board to date in connection with competitive service offerings by NJNG's retail affiliates; (b) established and maintained effective accounting separation between itself and its affiliates; and (c) established and maintained effective functional and management separation between itself and its affiliates. Moreover, the Final Report confirms that the customer impact of using utility assets to provide competitive services during the audit period was minimal, that the functional separation of appliance services from the utility did not significantly affect utility workers, and that the utility's practices did not have an impact on the market for competitive services.

Accordingly, there are only a limited number of characterizations in the Final Report that warrant a response and/or comment by NJNG to ensure that the record in this proceeding is accurate and complete. To that end, NJNG offers the comments noted below.

III. AUDIT RECOMMENDATIONS

The Final Report includes ten (10) audit recommendations, which are summarized on Pages 1-7 through 1-12. NJNG's position with respect to each is set forth in table format on Attachment A hereto, and in narrative format below.

1. (A1) Expand service agreements between NJNG and each individual affiliate that describe the nature, terms and prices to be charged for inter-company services [Finding 2-II-A]. **NJNG agrees** to work on such agreements.

2. (A2) Prepare periodic (monthly or quarterly) itemized statements of inter-company services and charges (including allocations) geared towards review by outside personnel in addition to the business units and departments being charged for the services [Finding 2-II-A]. **NJNG agrees** to prepare such statements.

3. (A3) Adjust the role of a non-managerial director in one affiliate to comply with Affiliate Standards or obtain permission for a variance from the BPU [Finding 2-II-B]. **NJNG agrees** to adjust that position or seek a variance, as suggested.

4. (B1) Improve procedural documentation and workpaper support for Service Corp and NJNG shared function cost allocations [Finding 2-II-A, Finding 3-II-C]. **NJNG agrees** to work on making such improvements.

5. (B2) Discontinue the use of the equity allocator, retain at NJR the executive and other corporate costs associated with non-utility corporate development and allocate remaining "residual" or "unattributable" costs in proportion with costs directly assigned and attributed [Finding 3-II-D]. **NJNG disagrees** with this recommendation. NJNG's use of equity as an allocator when common costs are not otherwise directly assignable is a long-standing, BPU-approved method of allocating such costs that, in the end, results in a fair and reasonable apportioning of costs. (See, order dated December 15, 1988, in BPU Docket No GE88050620.) The Final Report offers no compelling reason for NJNG to change that method; nor does the Final Report provide any support for the reasonableness of the alternative method suggested. In fact, NJNG's preliminary assessment of the alternative method suggested by the Final Report indicates that **more** (not fewer) costs would be assigned to NJNG if that alternative method were used than are currently assigned to NJNG under the equity allocator approach.

6. (B3) For each NJNG function shared with Home Services or another affiliate, identify, document, pool and allocate *all* common costs related to the function [Finding 3-II-E and 4-II-H]. **NJNG agrees** that common costs related to each NJNG function shared with Home Services should be identified and allocated to Home Services. In fact, NJNG already identifies and allocates such costs to Home Services, including costs relating to Home Service's direct usage of NJNG's AS-400 computer system. NJNG respectfully **disagrees** with the suggestion, however, that NJNG should identify and allocate additional O&M costs relating to the AS-400 system to Home Services. The referenced computer system was designed and developed to provide a complex variety of BPU-mandated customer service options for use by NJNG to better serve its customers; however, since Home Services neither needs nor is provided with the same number of customer service features, it would be unreasonable to allocate additional O&M costs relating to the AS-400 system to Home Services.

7. (B4) Adjust the discount applied to Home Services receivables (purchased by NJNG) to properly reflect the entire cost of credit, collections and bad debts [Findings 3-11-F]. **NJNG disagrees** with this recommendation. During the time period in which the BPU approved the transfer of NJNG's appliance service accounts to Home Services, NJNG charged marketers and brokers one half of one percent for credit, collection and bad debt services. It was accordingly reasonable for NJNG to apply the very same discount rate to Home Services' receivables purchased by NJNG. NJNG believes that discount rate continues to be reasonably reflective of its cost of providing credit, collections and bad debt services.

8. (C1) Establish controls to prevent NJNG customer service representatives (CSRs) from using NJNG's customer data while serving appliance services customers [Finding 4-II-D]. **NJNG agrees** with the proposed solution that NJNG should use system controls to prevent a CSR who is handling a call for Home Services from accessing NJNG customer information.

9. (C2) Include the prohibition against using customer data for appliance services in the NJR "Do's and Don'ts for Customer Service Representatives" policy [Finding 4-II-D]. **NJNG agrees** with this recommendation.

10. (C3) The BPU should carefully consider the competitive consequences of granting NJR permission to transfer "No Heat" calls to Home Services and provide NJR with instruction based on its consideration [Finding 4-II-G]. **NJNG agrees** with this recommendation.

IV. ADDITIONAL COMMENTS AND CLARIFICATIONS

Common Cost Allocations

Various references throughout Chapter 3 to the alleged lack of workpaper support for shared function allocations – until such time as the Draft Report was submitted – are unfair and misrepresent the nature of NJNG's good faith efforts to provide Overland Consulting with information during the audit process. Indeed, until the Draft Report was submitted, NJNG was unaware that Overland had been unable to establish an adequate audit trail, or that Overland required any additional information or assistance.

Page 4-15 (Section III.H.1.c)

Statement: "For several reasons, including a lack of scale economies, a smaller competitor would in most cases find a similar customer service information system and function to be more expensive, if not unaffordable."

Comment: NJNG is not aware of any market study or empirical support for this statement.

Prior Audit Recommendations

Page 1-7 (Section IV.H)

Statement: "We determined that NJNG fully implemented six of the recommendations adopted by the BPU as a result of the last audit. NJNG partially implemented a recommendation to develop an indirect cost allocation model (however NJR continues to use equity as an allocator for corporate costs). NJNG partially implemented a recommendation to develop a clearly written cost allocation manual and collect appropriate information to maintain it. The manual, as written, is insufficient to explain the processes used in allocating corporate costs and NJNG does not maintain all of the information necessary to support the allocations."

Comment: NJNG believes it **fully implemented all** of the recommendations adopted by the BPU as a result of the last audit. Nothing in the prior audit required NJR to entirely eliminate the use of equity as an allocator; it simply directed NJR to **reduce** its use of such an allocator. NJR reduced its use of such an allocation and, thus, fully implemented that recommendation. Similarly, nothing in the prior audit required NJNG to develop a line-item specific cost allocation manual or to collect and maintain supporting information in the format suggested; it recommended only that NJNG develop a clearly written cost allocation manual incorporating the prior audit's recommendations regarding general cost allocation principles. NJNG did develop an initial cost allocation manual and, thus, fully implemented that recommendation. The characterization that NJNG only partially implemented some of the prior audit recommendations is thus inaccurate. NJNG is nevertheless willing to consider making improvements to its cost allocation manual along the lines suggested, as well as maintaining the information necessary to support its allocations.

NJR's Energy Affiliates

The Final Report correctly notes that as a wholesale energy subsidiary, Energy Services is not subject to the BPU's Affiliate Standards. Chapter 5 nevertheless includes certain observations about the functional inter-relationships between NJNG and Energy Services, and its common management, and the potential for a conflict of interest in the event NJNG were to purchase services from Energy Services. See, *e.g.*, page 5-10. Since Energy Services is not subject to the Affiliate Standards, those observations are misplaced.

In addition, Overland suggests on pages 5-11 through 5-13 of Chapter 5 that NJNG's purchase of Stagecoach Storage capacity represents a potential conflict of interest, even though "nothing came to our attention during the audit to indicate that NJNG did not have a legitimate reason for acquiring storage at Stagecoach." The quoted statement, cast in the negative, understates the degree to which NJNG has supported its decision to competitively bid for and obtain Stagecoach Storage capacity. The Board's Staff and the Division of the Ratepayer Advocate have been provided with extensive documentation in support of NJNG's need for Stagecoach Storage capacity and the decision-making process which led to NJNG's competitive bid for that capacity. Furthermore, the value of this storage capacity during the winter season of 2002-2003 will be substantiated during the current NJNG BGSS proceeding. Therefore, NJNG strongly disagrees with the suggestion that its decision to competitively bid for and obtain Stagecoach Storage capacity represents in any way a potential conflict of interest.

If Board Staff has any questions regarding any of these corrections or comments, please feel free to contact either Timothy C. Hearne at (732) 938-1098, or Kevin A. Moss at (732) 938-1214.

Respectfully submitted,

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Attachment A

AUDIT OF THE COMPETITIVE SERVICE OFFERINGS OF
NJNG COMPANY
DOCKET # GA02020100

AUDIT RECOMMENDATIONS FROM DRAFT REPORT

Number	Recommendation	Response
A.	**Affiliate Transactions Documentation, Auditability and Internal Control (Chapter 2)**	
1.	Expand service agreements between NJNG and each individual affiliate that describes the nature, terms and prices to be charged for inter-company services. (Finding 2-II-A).	Agree to work on such agreements.
2.	Prepare periodic itemized statements of inter-company services and charges (including allocations) for review by the business units and departments being charged for the services (Finding 2-II-A).	Agree to prepare.
3.	Adjust the board membership of NJR subsidiaries to comply with Affiliate Standards or obtain permission for variances from the BPU (Finding 2-II-B).	Agree to change or seek a variance.
B.	**Shared Services and Common Cost Allocations (Chapter 3)**	
1.	Improve procedural documentation and workpaper support for Service Company and NJNG shared function cost allocations (Finding 2-II-A, Finding 3-II-C).	Agree to work on.
2.	Discontinue the use of the equity allocator, retain at NJR the executive and other corporate costs associated with non-utility corporate development and allocate remaining "residual" or unattributable" costs in proportion with costs directly assigned and attributed (Finding 3-II-D).	Disagree. Approach is based on long standing BPU-approved method and alternative proposed increases costs to utility.
3.	For each NJNG function shared with Home Services or another affiliate, identify, document, pool and allocate all common costs related to the function. (Finding 3-II-E).	Agree with the general principle but disagree in relation to allocation of costs related to AS-400 system which primarily benefits NJNG.
4.	Adjust the discount applied to Home Services receivables (purchased by	Disagree. Rate used is based on that

	NJNG) to properly reflect the entire cost of credit, collection and bad debts. (Finding 3-II-F).	charged to third party suppliers.
C.	**Shared Utility/Home Services Customer Functions and Databases (Chapter 4)**	
5.	Establish controls to prevent NJNG customer service representatives (CSRs) from using NJNG's customer data in serving appliance service customers (Finding 4-II-D).	Agree to use system controls to prevent a CSR who is handling a call for Home Services from accessing NJNG customer information.
6.	Include the prohibition against using utility customer data for appliance services in the NJR "Do's and Don'ts for Customer Service Representatives' policy.	Agree.
7.	The BPU should carefully consider the competitive consequence of granting NJR permission to transfer "No Heat" calls to Home Services and provide NJR with instruction based on its consideration.	Agree.